

## Preparation for an Audit

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### Learning objectives

After studying this chapter, you will be able to –

- ◆ Understand the preparation for an audit such as, auditor's engagement, audit process, audit techniques, procedures and planning.
- ◆ Draft audit programme, audit working paper, quality control of audit work and the elements of statistical sampling.
- ◆ Distinguish between different kinds of audit risk.

In the earlier chapter we have discussed the basic concepts of audit and the nature of evidence that is available to the auditor. Now we concern ourselves with how an auditor is to proceed for collection of evidence. Here starts the process of actual auditing. For effective work one has to frame a proper scheme of work and determine the techniques that are needed for collection of purposeful evidence. The scheme of auditing process envisages the following:

- (1) Formulating audit programme on the basis of knowledge of client's business.
- (2) Determination of the extent of checking on the basis of compliance procedures.
- (3) Carrying out the steps in the procedure on the basis of programme and the extent of substantive checking that may be required.
- (4) Keeping a record of notes and inquiries and maintenance of working papers.
- (5) Formulation of opinion about financial statements and review with reference to accounting standards.
- (6) Issuance of the audit report.

### 3.1 Auditor's Engagement

Accountancy and auditing are pursuits of a noble profession; the conduct of its members is governed by a set of the rules. One of the rules forbids chartered accountants to solicit clients. Clients must themselves find their auditors. A client is anybody or any entity which requires the service of a professional accountant for the audit of the accounts or for any other purpose. Clients may be individuals, partnership firms, companies, societies, clubs, trust, co-operative societies, government, etc.

**3.1.1 Agreement on Audit Engagement Terms:** Of these, the legal requirement to get the accounts audited so far extends only to companies, co-operative societies, and registered societies. In these cases the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract. The client tells the auditor the nature of service he requires and the auditor, if he is agreeable to undertake the assignment, specifies his terms. He must sign an agreement, if he accepts the work in terms of the agreement subject to professional standards. Clients who are not statutorily required to get their accounts audited may require preparation of accounts for tax-returns, checking of the sales tax-returns, etc. besides audit. There may be a misunderstanding about the exact scope of the work; the auditor may think that he is merely required to prepare accounts while the client may think audit of accounts is also covered. It is, therefore, of the greatest importance, both for the auditor and client, that each party should be clear about the nature of the engagement: it must be reduced in writing and should exactly specify the scope of the work. The audit engagement letter is sent by the auditor to his client which documents the objective and scope of the audit, the extent of his responsibilities to the client and the form of report. The ICAI has issued SA 210 "Agreeing the Terms of Audit Engagements" on the subject. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

In the case of partnerships, a few more precautions are needed. The appointment of the auditor is normally governed by the partnership deed. The accountant, when he is approached for undertaking a professional assignment by a firm or a partner of a firm, should first get a clear idea of the nature of the service required and then ensure, with reference to the terms of partnership agreement that his appointment is valid. Above all, he should bear in mind that all partners jointly and severally are his clients, though he might have been appointed by only one of them if so, authorised under the partnership deed. He must see that the individual interests of the partners have not been adversely affected in any manner and the provisions of the partnership deed regarding accounting have been fully given effect to.

According to SA 210 "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

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- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some entities, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law. The form and content of the audit engagement letter may vary for each entity.

***An Engagement Letter may need to be entered into for each year of the period covered by the Eligibility Letter issued by the auditor under section 139 of the Companies Act, 2013 and the Appointment Letter received from the Company, to supplement / update for any subsequent changes. This may be required because the appointment would need to be ratified at each AGM under section 139 of the said Act.***

**Recurring Audits:** In case of a recurring audit, the auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter-

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change in senior management, board of directors or ownership.
- A significant change in nature or size of the client's business.
- Legal requirements or pronouncements of the Institute of Chartered Accountants of India, or changes in the existing ones.

**3.1.2 Limitation on Scope Prior to Audit Engagement Acceptance:** If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

**3.1.3 Acceptance of a Change in Engagement:** An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider

carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:

- (a) the original engagement; or
- (b) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

- (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
- (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

**[Note: Provisions relating to appointment of Auditors, qualifications, disqualifications etc. as per the Companies Act, 2013 are discussed separately in Chapter 7]**

## 3.2 Audit Process

One must take care to ensure that nothing is missed in the process which needs to be followed to achieve the audit objective. The following audit process in that order may be taken as a specimen:

- (a) Formulating audit plan and laying down broad framework for conducting the work and method to ensure control over the quality of work.
- (b) Examination and evaluation of the nature, extent and efficacy of the system of internal control. The nature, extent and timing of substantive procedures, would depend upon the extent of satisfaction an auditor obtains after evaluating the internal control system. The determination of extent of test checking would also depend upon the same.
- (c) Ascertaining the arithmetical accuracy of the books of account by checking posting, casting, crass-casting, carry forwards, opening and closing balances, etc.

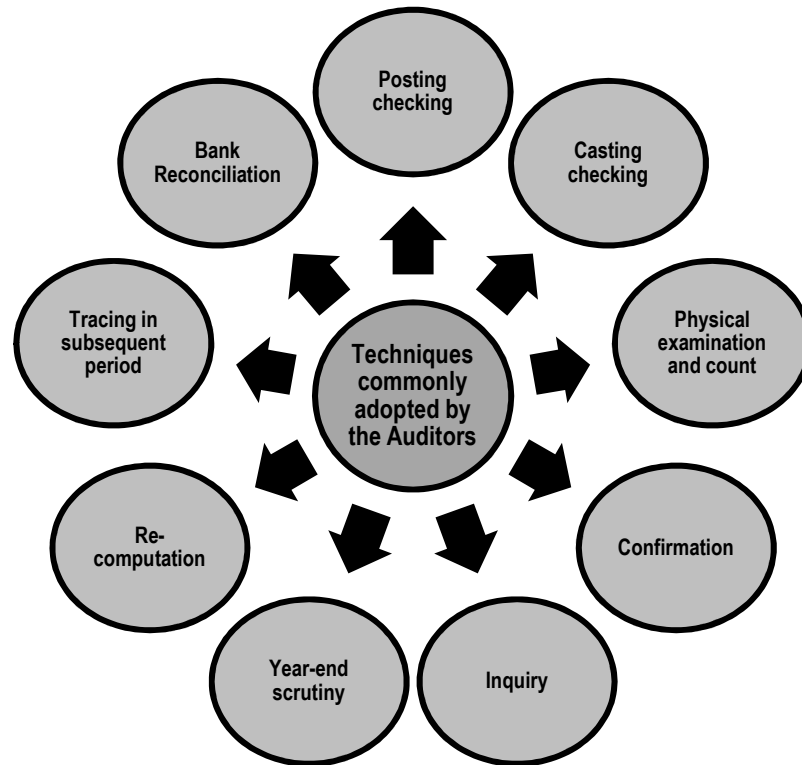
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- (d) Examining the documentary evidence (both internal and external) and the authority in support of the transaction, i.e. vouching.
- (e) Checking the validity of transactions with reference to:
  - (i) provisions affecting the accounts and audit in any Act or Rules;
  - (ii) rules and regulations governing the constitution and management of the organisation i.e., the memorandum and articles of association in the case of a company, partnership deed in the case of a firm, trust deed in the case of a trust and bye-laws in the case of a co-operative society;
  - (iii) minute books for appropriate sanction of the transactions by competent authority;
  - (iv) other legal documents such as the prospectus, returns submitted to legal authorities, contracts and agreements e.g., vendors' agreement, lease agreement, selling agency agreement, collaboration agreements, etc; and
  - (v) well recognised accounting principles and practices e.g., distinction between capital and revenue, accrual system of accounting, valuation principles, etc.
- (f) Ensuring that there is adequate disclosure of information and, in particular, the annual accounts are prepared in such a manner as to convey the real picture about the assets and liabilities and of the operating result (profit or loss) of the organisation. For this purpose, the auditor must conform to the prescribed legal requirement, if any, as to the form of accounts and have due regard to the best current accounting practice. Reference to Schedule III of the Companies Act, 2013 in case of companies and compliance with accounting standards will have to be seen.
- (g) Verification of existence, ownership, title and value of the assets and determination of the extent and nature of liabilities.
- (h) Scrutiny of the accounts to establish reasonableness, consistency and compliance with the legal requirements.
- (i) Application of various overall checks in order to test the overall reliability of the accounting records and the statements and to see whether the results of overall checks corroborate the findings already made.
- (j) Determination of the significant accounting ratios and subjecting the accounts to ratio analysis to locate the areas showing departure from the expected state of affairs.

### **3.3 Audit Techniques**

For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques.



Some of the techniques commonly adopted by the auditors are the following:

1. Posting checking
2. Casting checking
3. Physical examination and count
4. Confirmation
5. Inquiry
6. Year-end scrutiny
7. Re-computation
8. Tracing in subsequent period
9. Bank Reconciliation.

The two terms, procedure and techniques, are often used interchangeably. However, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence. Recall the audit procedures as discussed in Chapter 2 “Basic concepts in Auditing”.

### **3.4 Audit Planning**

“The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client’s business.

Plans should be made to cover, among other things:

- (a) acquiring knowledge of the client’s accounting systems, policies and internal control procedures;
- (b) establishing the expected degree of reliance to be placed on internal control;
- (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
- (d) coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.”

SA-300, “Planning an Audit of Financial Statements” further expounds this principle. According to it, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

**In establishing the overall audit strategy, the auditor shall:**

- (a) Identify the characteristics of the engagement that define its scope;
- (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- (c) Consider the factors that, in the auditor’s professional judgment, are significant in directing the engagement team’s efforts;
- (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

**The auditor shall develop an audit plan that shall include a description of:**

- (a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment”.
- (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 “The Auditor’s Responses to Assessed Risks”.
- (c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The overall audit plan and the audit programme, however, remain the auditor's responsibility.

**3.4.1 Knowledge of the Client's Business:** It is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment" the auditor shall obtain an understanding of the following:

- (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
- (b) The nature of the entity, including:
  - (i) its operations;
  - (ii) its ownership and governance structures;
  - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
  - (iv) the way that the entity is structured and how it is financed;to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
- (e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgements regarding the appropriateness of accounting policies and disclosures.

**3.4.2 Development of an Overall Plan:** The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.



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- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

The auditor should document his overall plan. The form and extent of the documentation will vary depending on the size and complexity of the audit. A time budget, in which hours are budgeted for the various audit areas or procedures, can be an effective planning tool.

**[Student may also refer SA 300, “Planning an Audit of Financial Statements” for better understanding]**

**3.4.3 Developing the Audit Programme:** The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.

In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are

other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.

The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

### 3.5 Audit Programme

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is nothing but a list of examination and verification steps to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client. In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. Because of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped. The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

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There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences. For example, if the audit programme for the audit of a branch of a financing house, drawn up a number of years ago, fails to take into consideration that the previous policy of financing of a vehicle has been changed to financing of real estate acquisition, the whole audit conducted there under would be entirely misdirected and may even result into nothing more than a farce. [*Pacific Acceptance Corporation Ltd. v. Forsyth and Others.*]

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unflinchingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review mentioned earlier is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements.

**For the purpose of programme construction, the following points should be kept in view:**

- (1) Stay within the scope and limitation of the assignment.
- (2) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- (3) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
- (4) Consider all possibilities of error.
- (5) Co-ordinate the procedures to be applied to related items.

Amplification is not necessary of the above points except the one under evidence: that is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact;

procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

By evidence we mean the material, documentary or otherwise, available to prove or disprove the assertions made in the statement of accounts through the entries in the books of account. For example, sales are evidenced by:

- (i) invoices raised by the client;
- (ii) price list;
- (iii) forwarding notes to client;
- (iv) inventory-issue records;
- (v) sales managers' advice to the inventory section;
- (vi) acknowledgements of the receipt of goods by the customers; and
- (vii) collection of money against sales by the client.

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

You may recall from chapter 2 on basic concepts in auditing that an auditor picks up evidence from a variety of fields and it is generally of the following broad types:

- (a) Documentary examination,
- (b) Physical examination,
- (c) Statements and explanation of management, officials and employees,
- (d) Statements and explanations of third parties,
- (e) Arithmetical calculations by the auditor,
- (f) State of internal controls and internal checks,
- (g) Inter-relationship of the various accounting data,
- (h) Subsidiary and memorandum records,
- (i) Minutes,
- (j) Subsequent action by the client and by others.

By "good evidence" we mean highly satisfactory evidence available without any special effort or cost. For cash in hand the best evidence is 'count'; in respect of investment pledged with a bank, the banker's certificate. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion. The auditor, however, has to place appropriate weight on each piece of

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evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word “available” we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

For testing the authenticity of the client as regards amount lying with bank, the auditor adopts the following procedure:

- (1) Examination of the counterfoils of cheques and paying-in-slips and comparing them with the entries in the concerned ledger account of the client.
- (2) Checking the castings, carry over and balances of the ledger account.
- (3) Comparison of the entries in the ledger with the bank statement (this is the reproduction of the ledger account maintained by the bank for recording the transactions with the client).
- (4) Examination of the bank reconciliation statement to know the items that explain the difference, if any, between the balance shown by client's ledger and the bank statement.
- (5) Scrutiny of the subsequent period's bank statement to ensure that items entering for reconciliation have been duly entered by the bank on clearance or presentation.
- (6) Verification of official confirmation of the balance by the bank.

If you analyse these procedures, you will see that each provides the auditor with some evidence which by itself is not adequate even if the result is satisfactory. The first one proves that the entries conform to the underlying records, but the *prima facie* authenticity of the underlying record is corroborated by a checking of the bank statement. The second provides evidence of the arithmetical accuracy. Procedure under step four, screens the items of difference between the two records and the *bonafide* of that statement is proved by step five. Sixth and the last step is most significant because the reliability of the bank statement is much enhanced by confirmation of the balance on a specified date made by a responsible official of the bank. But all these cannot give the auditor a degree of confidence or conclusiveness because he has no access to the bank's books and records. Therefore, he must be contented with the best available evidence to arrive at a reasonable opinion.

At times, the available evidence on a single assertion may be found to be contradictory. For example, sales in quantity and value, as evidenced by some of the procedures enumerated above, may not be corroborated by a quantitative analysis of the opening inventory, production, sales and closing inventory. In such a situation, it would be the duty of the auditor to call for the explanation of the management before he accepts or rejects any of the contradictory evidence for the purpose of formulation of his opinion on the particular matter. Only by properly considering and evaluating the explanation of the management, the auditor is in such a situation as would enable him to accept or reject any of the evidence.

**Advantages and Disadvantages of the use of an Audit Programme**

The **advantages** of an audit programme are:

- (a) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- (b) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- (c) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- (d) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, the danger is significantly less and the audit can proceed systematically.
- (e) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- (f) The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- (g) It serves as a guide for audits to be carried out in the succeeding year.
- (h) A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

Some **disadvantages** are also there in the use of audit programmes but most of these can be removed by taking some concrete steps. The disadvantages are:

- (a) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- (b) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation or conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.
- (c) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
- (d) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the

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assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

## 3.6 Methods of Work

In order that an audit may be carried out in a systematic and efficient manner, the following steps should be taken:

- (1) Work must be carried on regularly and record kept of time of arrival/departure of the staff and also of the work done each day;
- (2) As far as possible, a definite portion of the work should be completed each day so that loose ends are not left over for being tied up at a later date;
- (3) Entries should be made in the audit note book and the audit programme initialed as a routine;
- (4) Colored pencils and different type of ticks must be employed to indicate the various audit processes which have been applied and their significance must not be disclosed to the client;
- (5) All the vouchers after examination must be immediately cancelled with an audit stamp;
- (6) Staff members should refrain from discussing the client's affairs amongst themselves and with outsiders.

## 3.7 Continuous and Final Audit

**Final or Completed or Periodical Audit:** A final or completed audit is commonly understood to be an audit which does not begin until the books have closed at the end of the accounting period and thereafter is carried on continuously until completed. Whether an audit ought to be conducted continuously after the close of the financial year should be decided on a consideration of the size of the business and the extent of detailed checking required.

**Advantages** of such an audit are:

- (i) Work can be carried on till the audit is over, thus, avoiding the necessity of having to return on separate occasions to complete the work.
- (ii) The possibility of figures being altered after work has been done is also avoided.
- (iii) Allocation of work for staff also becomes easier.

**Disadvantages** of final or completed audit include may be mainly on account of delay which may occur after the end of the financial period particularly if size of the business is large; accounting periods of several clients may end on the same date, and thus difficulties may be experienced in allocating audit staff.

**Continuous Audit:** A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client the whole year round or when for this purpose the staff attends at intervals, fixed or otherwise, during the currency of the financial

period. Strictly speaking, when auditor's staff attends the audit work at fixed intervals it may be strictly called interim audit. This is when an audit is conducted up to a particular date within the accounting period. The auditor may attend to audit the figures for a month or for a quarter, as the work may require. It would differ distinctly from the final audit in the extent of the work carried out; verification of assets, for example would be left until the final audit. In case of continuous audit, the work is conducted throughout the course of the financial year but is not taken to a specific accounting period, as is an interim audit. It might be that during the course of the continuous work interim figures are being audited, but the significant factor here is that the auditor will be engaged continuously on the audit throughout the financial period. Staff may be in residence throughout the period or may come and go at irregular intervals, but most of the time, the audit staff is present at the location. Thus, in case of continuous audit, the audit staff is present at the client's premises almost during the entire accounting period.

**Advantages:**

- (1) Errors are discovered earlier with the result that there is adequate time for making the necessary rectification.
- (2) Because of the frequent attendance of the auditor, the opportunities of committing frauds are reduced.
- (3) Fraud, if perpetrated, is detected sooner with the result that size of the fraud is limited and also the chances of recovering the amount lost are improved.
- (4) The attendance of the audit staff acts a moral check on the client's staff.
- (5) The client's accounts are always kept up-to-date.
- (6) Since audit can be carried on throughout the year, there is more time for detailed checking of the accounts when the audit is taken up at the close of the year.
- (7) If the audit of routine transactions is completed before the close of the year, the final accounts can be prepared and reported upon much earlier.
- (8) If the auditor carries on a continuous audit, he remains constantly in touch with the client's affairs thereby able to carry out his duties efficiently.
- (9) In the case of continuous audit, the work of the auditor is greatly facilitated since he is in a better position to plan out his engagements and take up the job at his convenience, avoiding the pressure at the close of the financial year when most of the business firms usually close their accounts.

**Disadvantages:**

- (1) There is a danger that the records of transactions after they have been audited may be altered either innocently or fraudulently.
- (2) The examination of an item left incomplete on a visit for being undertaking on the next visit may be overlooked.



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- (3) A continuous audit may involve good deal of waste of time and effort if the size of the concern is small.

**The disadvantages of a continuous audit can be avoided if the following precautions are taken:**

- (1) During the course of each visit, work should be completed upto a definite stage so as to avoid loose ends.
- (2) At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.
- (3) The visits should be at irregular intervals of time so that the client's staff may not in advance know the exact date when the audit would be resumed and thus may be able to prepare themselves in advance for the same.
- (4) The nominal accounts should be checked only at the time of final closing.
- (5) The client's staff should be instructed not to alter or correct audited figures. The auditor should also device a special form of ticks for being placed against figures which have been altered and neither its purpose nor significance should be disclosed to the client's staff.

Thus, it is clear from the above that final or completed audit approach is advisable in case size of the entity is very small. On the other hand, continuous audit may be followed only in case size of the entity is very large and system of internal control is weak since the great disadvantage of continuous audit is that the cost would be very high and continuous presence of audit staff may impair auditor's independence. The interim audit conducted on quarterly or half-yearly basis is the most practicable solution.

## 3.8 Audit Planning and Materiality

As stated in the previous chapter, materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true or fair view or not. SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit. When planning the audit, the auditor considers what would make the financial information materially mis-stated. The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. Students may note that the auditor's assessment of materiality and audit risk may be different at the time of initially planning of the audit as against at the time of evaluating the results of audit procedures.

### 3.9 The Overall Audit Approach

The auditor must gather sufficient competent evidential matter as a basis for forming his opinion on:

- (a) the truth and fairness of the accounts and also their compliance with the provisions of the related laws, rules and regulations;
- (b) the proper keeping of the accounting records, and other records and related registers of the client.

These broad objectives may be amplified as follows:

*To determine whether:*

- (1) all assets and liabilities are properly stated and classified on a basis consistent with that of the previous year;
- (2) proper disclosure is made of securities for liabilities and of assets charged or secured;
- (3) the client has complied with the provisions of the applicable laws and documents created under them, loan agreements and other documents to which he is a party;
- (4) income and expenses are properly classified and disclosed and are properly matched. They relate to the period in which they are reported and have been determined on a basis consistent with that of the previous year;
- (5) all contingencies and commitments are properly disclosed;
- (6) no material omissions have been made in the financial statements;
- (7) no material error or inaccuracy in reporting or disclosing income, expenses, assets and liabilities has been created in the financial statements;
- (8) the books and records have been properly kept in accordance with the requirements of the client.

The expression of opinion on the overall balance sheet and statement of profit and loss involves initially forming an opinion on each of the balance sheet or profit and loss items; it is necessary first to decide what are the essential conditions or pre-requisites for each balance sheet or statement of profit and loss item in order to give a true and fair view of the particular assets or liabilities or item of income or expense being represented. These conditions are well established and may be illustrated by reference to the areas of trade receivables and sales revenues.

**Trade Receivables:** The audit of sundry trade receivables should be sufficiently comprehensive to enable the auditor to form an opinion as to whether:

- (1) The amounts shown represent *bonafide* receivables of the company.
- (2) The receivables are properly classified.

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- (3) Adequate provisions have been made for uncollectible receivables and for discounts and freight allowable, returns adjustments, etc.
- (4) Any receivables have been pledged, discounted, assigned or sold, and if so whether they are properly disclosed.

**Sales Revenues:** Specific objectives in the audit of sales revenues are to determine whether:

- (1) Sales accounting procedures are operating effectively to produce reliable sales revenue figures for the period.
- (2) Sales revenues have been recorded in the proper accounting period and are not overstated through improper credits for fictitious sales of goods neither supplied nor set aside. Conversely, whether sales or other revenues are understated through deferring the recording thereof to subsequent periods or omitting to record sales despatched as sales.
- (3) Allowance, returns and other sales deductions are fairly stated and properly treated in the financial statements and that adequate provisions have been made for any significant additional amount that may be anticipated to be paid but not yet finally settled.
- (4) Non-operating revenues have been segregated from sales revenues and have been appropriately treated in the statement of profit and loss.

### 3.10 Audit Working Papers

The audit working papers constitute the link between the auditor's report and the client's records. According to SA-230, Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used). The objects of an auditor's working papers are to record and demonstrate the audit work from one year to another.

Audit documentation serves a number of purposes:

- ◆ Assisting the engagement team to plan and perform the audit.
- ◆ Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- ◆ Enabling the engagement team to be accountable for its work.
- ◆ Retaining a record of matters of continuing significance to future audits.
- ◆ Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- ◆ Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

**Working papers are varied in nature.** They may be recorded on paper or on electronic or other media. Examples include:

- ◆ Audit programmes.
- ◆ Analyses.
- ◆ Issues memoranda.
- ◆ Summaries of significant matters.
- ◆ Letters of confirmation and representation.
- ◆ Checklists.
- ◆ Correspondence (including e-mail) concerning significant matters.

The auditor may include abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) as part of working papers. Working papers, however, is not a substitute for the entity's accounting records.

The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Oral explanations by the auditor, on their own, do not represent adequate support for the work auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the working papers.

The foundation of all working paper can be traced to:

- (1) the basic constitutional documents like Memorandum and Articles of Association, Partnership Deed, Trust Deed, etc.;
- (2) the contents of the minute books;
- (3) the contents of the balance sheet and the statement of profit and loss; and
- (4) the letter of engagement.

**3.10.1 Form and Content of Working Papers:** Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

The form, content and extent of working papers depend on factors such as:

- ◆ The size and complexity of the entity.
- ◆ The nature of the audit procedures to be performed.
- ◆ The identified risks of material misstatement.
- ◆ The significance of the audit evidence obtained.
- ◆ The nature and extent of exceptions identified.
- ◆ The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- ◆ The audit methodology and tools used.

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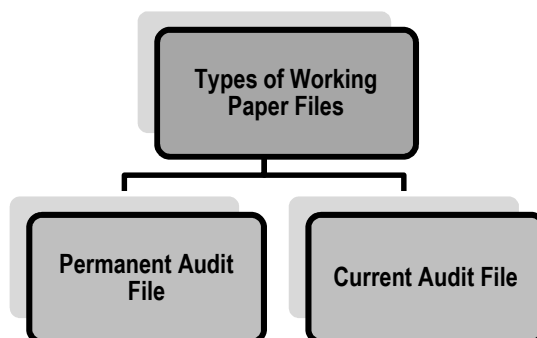
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Working papers should be designed and properly organised to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardisation of working papers (for example, checklists, specimen letters, standard organisation of working papers) improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of the documentation is a matter of professional judgment since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

All significant matters which require the exercise of judgment, together with the auditor's conclusion thereon, should be included in the working papers.

To improve audit efficiency, the auditor normally obtains and utilises schedules, analyses and other working papers prepared by the client. In such circumstances, the auditor should satisfy himself that these working papers have been properly prepared. Examples of such working papers are detailed analysis of important revenue accounts, receivables etc.

In the case of recurring audits, some working paper files may be classified as permanent audit files which are updated currently with information of continuing importance to succeeding audit, as distinct from current audit files which contain information relating primarily to the audit of a single period.



**A permanent audit file normally includes:**

- Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.

- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

**The current file normally includes:**

- Correspondence relating to acceptance of annual reappointment.
- Extracts of important matters in the minutes of Board Meetings and General Meetings as relevant to audit.
- Evidence of the planning process of the audit and audit programme.
- Analysis of transactions and balances.
- A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- Evidence that the work performed by assistants was supervised and reviewed.
- Copies of communication with other auditors, experts and other third parties.
- Letters of representation or confirmation received from the client.
- Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial information being reported on and the related audit reports.

**3.10.2 Audit Note Book:** An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. It is thus a part of the permanent record of the auditor available for reference later on, if required. The audit note book also provides a valuable help to the auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily because in it are recorded along with observations, the various queries, explanations obtained and evidence seen, while queries remaining undisputed or would be noted for follow up. It is more satisfactory in some ways, however, to use loose sheets for entering queries and notes which, subsequently, on being punched, may be filed in a special query file maintained for each client or along with the clients' accounts and papers, separately for each year.

**Significant matters observed during the course of audit, a record of which should be kept in the Audit Note Book:**

- (a) Audit queries not cleared immediately e.g. missing receipts, vouchers, etc.

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- (b) The mistakes or irregularities observed during the course of audit e.g. cases of failure to comply with the requirements of the Companies Act, 2013 or the provisions contained in the Memorandum or Articles; a change in the basis of valuation of finished inventory and work-in-progress or in the computation of depreciation; failure to provide adequate depreciation, etc.
- (c) Unsatisfactory book-keeping arrangements, costing method, internal or financial administration or organisation.
- (d) Important information about the company which is not apparent from the accounts.
- (e) Special points requiring consideration at the time of verification of final accounts.
- (f) Important matters for future reference.

*Specimen of entries in an Audit Note Book to indicate the manner in which entries in those books ought to be made:*

#### Queries-Vouchers-Cash Book Payment

Voucher	Account Debited	₹	Query	How disposed of
38	Advertisement	2,01,600	Managing Director's sanction required	Sanction obtained
107	Rent	81,500	Rent bill & receipt required	Receipt & bill obtained
306	Das & Co.	5,23,474	Receipt required	Party reminded
42	Machinery	15,49,160	Board's sanction required	Sanction obtained minute dated 10-1-15
89	Stores	37,403	Invoice required	Party reminded
128	Raw material	83,457	Rates for items (i) & (ii) are different from those on the purchase order	Items of the quality ordered not being available, a better quality was accepted under purchase officer's approval.

The making of intelligent enquiries on the accounts under audit is an important part of the work of an auditor. However, to guard against the client's staff being required to provide explanation and information which are unnecessary or which could be ascertained otherwise junior members of the audit staff should be allowed to raise audit queries only after obtaining the prior approval of the senior in charge. Nonetheless, the enthusiasm of an intelligent and energetic junior should not go unrewarded and, as such, the queries he wishes to raise and which are not pertinent or important should be discussed and explained to him.

The audit notes constitute important evidence of matters considered by the auditor during the course of the audit, some of which may not find a place in his report submitted to the

shareholders or directors, for the reason that on the basis of an explanation given to him by the management, he, on being satisfied, decided to drop them. As such, audit notes can be an important defence for the auditor in the event of an action for negligence in the discharge of his duties being subsequently brought against him.

In the past, these have been used for successfully defending a legal action brought against an auditor alleging negligence in performance of his duties. For instance in the case of *City Equitable Fire Insurance Company Limited* the auditor was greatly assisted in his defence by the well maintained record of work that had been carried out by him in regard to the audit. The necessity of maintaining a systematic record of audit queries also was greatly emphasised by Lord Justice Williams while delivering the judgment in the case of *London and General Bank*.

Audit notes can also serve as a guide in framing audit programme in the future as they indicate the weaknesses in the system of the client which specially need to be watched.

Also, it is desirable that the audit notes, whether they are kept in a book or in loose sheets, should bear a reference to the particular item of work in the audit programme, and as far as practicable, all notes relating to the particular work in the programme should be kept together in the systematic order.

**3.10.3 Ownership and Custody of Working Papers:** Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client. Audit working papers are the property of the auditor and he is entitled to retain them. (*Chantery Martin & Co. v. Martin*).

**Retention Period:** *Firms are required to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.*

**Documentation:** *The auditor shall document-*

- (a) *The overall audit strategy;*
- (b) *The audit plan; and*
- (c) *Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.*

### 3.10.4 Importance of Working Papers

- (i) It provides guidance to the audit staff with regard to the manner of checking the schedules.
- (ii) The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.
- (iii) It acts as evidence in the court of law when a charge of negligence is brought against the auditor.



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- (iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

**Clarification on the Auditors' Rights where Clients and Other Auditors seek access to their Audit Working Papers:**

- (1) The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose. SA 230 on "Audit Documentation" read with Standard on Quality Control (SQC) 1 "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.
- (2) Part I of the Second Schedule to the Chartered Accountants Act, 1949, provides that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force.
- (3) Requests are sometime received by the members of the Institute, who have/had been performing the duties as the auditors of an enterprise, to provide access to their audit working papers. The requests may be made by the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise.
- (4) It is hereby clarified that except to the extent stated in para 5 below, an auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term 'auditor' includes 'internal auditor'.
- (5) As stated in Para 4 above, the client does not have a right to access the working papers of the auditor. However, the auditor may, at his discretion, in cases considered

appropriate by him, make portions of or extracts from his working papers available to the client.

### 3.11 Quality Control for Audit Work

An audit is a complex task involving number of people at different levels. As we observed in the preparation and development of audit programme, the auditor would naturally have to depend upon number of technical experts as well. During the course of his work, the auditor is also likely to use the work performed by other auditors also. A lot of work is also delegated by him to his assistants. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose. SA 220, "Quality Control for an Audit of Financial Statements" lays down standards on the quality control. The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and regulatory and legal requirements; and
- (b) The auditor's report issued is appropriate in the circumstances.

#### Requirements

**Leadership Responsibilities for Quality on Audits:** The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

**Relevant Ethical Requirements:** Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team.

If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.

**Independence:** The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

- (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- (b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- (c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit

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engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

**Acceptance and Continuance of Client Relationships and Audit Engagements:** The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.

If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

**Assignment of Engagement Teams:** The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

- (a) Perform the audit engagement in accordance with professional standards and regulatory and legal requirements; and
- (b) Enable an auditor's report that is appropriate in the circumstances to be issued.

#### **Engagement Performance**

**Direction, Supervision and Performance:** The engagement partner shall take responsibility for -

- (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and
- (b) The auditor's report being appropriate in the circumstances.

**Reviews:** The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

**Consultation:** The engagement partner shall -

- (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
- (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

- (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- (d) Determine that conclusions resulting from such consultations have been implemented.

**Engagement Quality Control Review**

- (1) For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:
  - (a) Determine that an engagement quality control reviewer has been appointed;
  - (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
  - (c) Not date the auditor's report until the completion of the engagement quality control review.
- (2) The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:
  - (a) Discussion of significant matters with the engagement partner;
  - (b) Review of the financial statements and the proposed auditor's report;
  - (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
  - (d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.
- (3) For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:
  - (a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;
  - (b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
  - (c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached.

**Differences of Opinion:** If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

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**Monitoring:** An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

**Documentation:** The auditor shall document -

- (a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
- (b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
- (c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
- (d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

The engagement quality control reviewer shall document, for the audit engagement reviewed, that:

- (a) The procedures required by the firm's policies on engagement quality control review have been performed;
- (b) The engagement quality control review has been completed on or before the date of the auditor's report; and
- (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

**(Note: Student may refer SA 220 reproduced in Auditing Pronouncements for better understanding of the topic)**

### 3.12 Elements of Statistical Sampling

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention of the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor; there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do is to express his opinion and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On a consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognised basis. Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability.

**The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:**

- (i) Size of the organisation under audit.
- (ii) State of the internal control.
- (iii) Adequacy and reliability of books and records.
- (iv) Tolerable error range.
- (v) Degree of the desired confidence.

It has already been pointed out that in most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organisation because they provide the reliability of the records. What should be the extent of desirable checking in any particular matter is for auditor to judge on basis of his opinion about the state of control in a particular area. If control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains. On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have

some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case. For example, Mr. X may consider that in his estimation of stores valuation, an error of 2% may not be material; he also decides that he needs at least 98% reliability of the result. He is to pick up the requisite number of items of the stores for reliability of the result. The requisite number he can get from the random number table. The question of reliability of the result is directly linked with the reliability of the internal control and of the books and records; when these are satisfactory, lesser degree of reliability of the sampling estimation may suffice — if these are not satisfactory, the auditor may have to decide upon a higher degree of reliability which can only be obtained from a larger sample.

**3.12.1 Test Checking:** Very often we come across this term when an audit is conducted on the basis of a part checking. This, it is said, owes its origin to the statistical theory of sampling.

The auditor according to his best judgment, having regard to the nature, size and materiality of transactions, picks up the entries for examination. Normally, entries involving large amounts or relating to material accounts are seen exhaustively and entries are picked up for verification at random from the remainder according to a certain plan. Sometimes, entries are checked for a few specified months exhaustively and the rest go unchecked. Though it is stated that the technique is an adaptation of the sampling theory, it is in reality far from it. It lacks any acceptable basis and gives the auditor no idea about the degree of reliability that he can place on the findings for application to the whole set of entries. The so-called random picking is not random in the statistical sense. To be truly random, the selection should be free from any bias and that is possible only through a statistical process and by reference to the random number tables.

The only quality that this technique can claim lies in its keenness to cover larger amounts and material accounts. Even if errors, frauds etc., remain undetected in the part not checked, they are not likely to be too big as to upset the truth and fairness of the financial statement. But auditors cannot be certain about this even after checking 100% of transactions. The cost and time involved in conducting an audit has to be visualized in relation to benefits which shall accrue from such an approach. If fairly lesser amount of checking may lead to admit same conditions there is absolutely no point in checking entire transaction. Moreover, there are constraints within which audit has to be completed.

In any audit, the question of fact is more important because essentially the auditor's job is to test the assertions in financial statements by reference to available evidence, apart from the following aspects:

- (i) presentation,
- (ii) disclosure,
- (iii) arithmetical accuracy,
- (iv) adherence to accepted accounting principles, and

- (v) compliance with the requirements of law.

An auditor is also concerned about the existence of errors and frauds in the financial accounts. The few matters listed above are fundamental questions affecting the true and fair concept and due consideration to these are given at the appropriate stage of audit. However, errors and frauds stand on a slightly different footing inasmuch as there is a need to eliminate them if they exist to affect truthfulness and fairness materially. It is therefore necessary that an auditor should have a fair idea about why error and frauds occur, how they are committed and what are the usual means to locate them.

**3.12.2 Precautions to be taken in Adopting Test Checking Techniques:** Generally, a large manufacturing concern is associated with a large volume of transactions. Also, the nature of the transactions is determined by the nature of the business. For example, one may find numerous purchases of raw materials, stores, spares, etc.; there may be thousands of workers to be paid wages on weekly basis; the wages again may be calculated on a job or time basis. Depending upon the product lines, the sales mechanics may be different for different products - some may be to dealers and agents, some to wholesalers and some others even to retailers and consumers directly. Sales and purchase operations may stretch even to overseas markets. There may be various forms in which such a concern can raise bank finance, like letter of credit, packing credit, overdraft, bills discounted, etc. Basically, in a large manufacturing concern the problem is the problem of volume and variety.

In the circumstances when necessarily the test check technique has got to be adopted for audit work, it should be done by taking certain precautions so that a reliable idea about the truth and fairness of the accounts can be obtained by the auditor.

**The precautions that should be taken may be the following:**

- (i) The transactions of the concern should be classified under appropriate heads and may be stratified if wide variations are there between transactions of the same kind.
- (ii) Systems and procedures for entering into and processing a transaction right from the beginning to the end should be studied in a sequential order. It involves questions of authorisations, documentation and recording and evidencing the same.
- (iii) The whole of the system of internal control in the areas of accounts and finance should be studied and evaluated for its efficiency, soundness and capability for producing reliable accounting and financial data. This can be done by studying the controls and internal checks, evaluating their general soundness in the context of the business of the concern and testing their actual operation. If, and only if, the auditor is satisfied about soundness of the controls and their operation in actuality, can he decide to have test checks. For testing the operation of the control system, he should select a few transactions and check them in depth by the application of procedural tests.



### 3.33 Auditing and Assurance

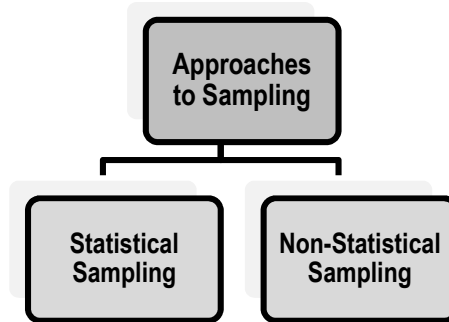
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- (iv) A properly thought-out test check plan should be prepared and the objective of each check should be clearly understood by the auditing staff. For example, each voucher may be checked by the test check method for a number of objectives - one may be to ensure that the cash payments are properly authorised and acknowledged, others may be to see whether the amount actually payable has in fact been paid and whether the payment has been debited to the proper account. If there is a mix-up in the objectives or the objective is to test a number of variables in one test scheme, the result may not be helpful. Hence it requires a clear definition of the audit objective related to the particular test check plan.
- (v) The transactions falling under each test-check plan should be selected in a manner so that bias cannot enter in the selection. For the purpose, selection should be made by reference to the random number tables.
- (vi) Identification of the areas where test check may not be done. For example, if there are only 20 overseas sales in the year, it would be preferable to have them all thoroughly checked.
- (vii) The number of transactions to be selected for each test-check plan should be predetermined. This can be done by deciding upon the degree of reliance that should be placed on the test-check result and the confidence that can be placed - the result to be obtained should be veering round the degree of reliance set up. Once the degree of reliance and the confidence level required in the audit for expression of the opinion have been decided, the number to be tested out of the given population can be easily known by reference to the statistical tables.
- (viii) Errors that may be found may be material or immaterial in the context of the particular audit. Since errors of immaterial nature are not likely to distort the overall truth and fairness of the accounts, it is necessary to decide upon the criteria to judge what constitutes a material error. Further investigation of immaterial error may be avoided and only the material errors may be properly and thoroughly investigated.

**3.12.3 Audit Sampling:** According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected. Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

**Approaches to Sampling:**

The approaches to sampling are: (1) Statistical sampling; and (2) Non-statistical sampling.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

**Statistical Sampling:** Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

Students may note that it is unnecessary for the auditor to gain in depth knowledge of statistics before making use of statistical sampling for audit testing since published statistical tables are available which indicate the sample size based on pre-determined criteria.

**Non-statistical Sampling:** Under this approach, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This approach has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June and September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

The non-statistical sampling is criticised on the grounds that it is neither objective nor scientific. The expected degree of objective cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated. The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques. However, it may be stated that the auditor with his experience and knowledge of the client's business can evaluate accurately enough the sample findings to make audit decision and the mathematical proof of accuracy in some cases may be a luxury which the auditor cannot afford.

In non-statistical sampling the auditor's opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective. In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives.

**Sample Design, Size and Selection of Items for Testing:** When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

**Performing Audit Procedures:** The auditor shall perform audit procedures, appropriate to the purpose, on each item selected. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details.

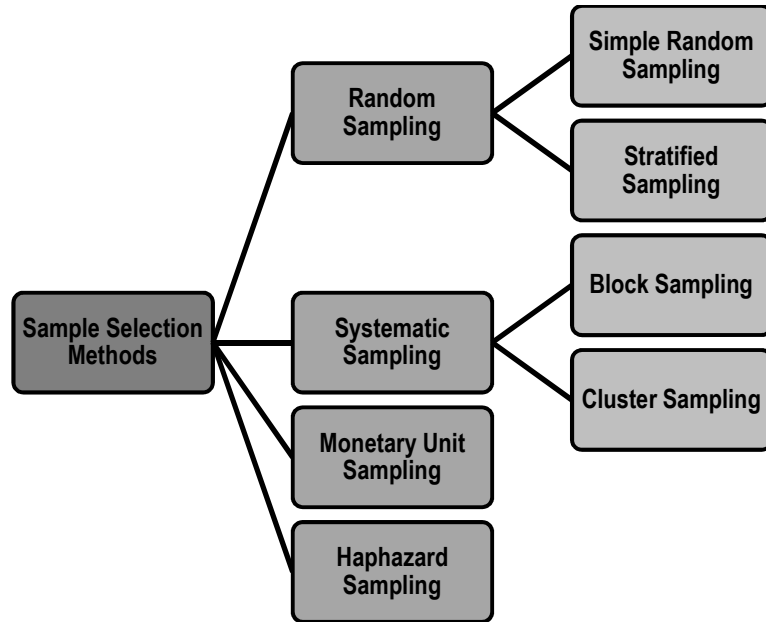
**Nature and Cause of Deviations and Misstatements:** The auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

**Projecting Misstatements:** For tests of details, the auditor shall project misstatements found in the sample to the population.

**Evaluating Results of Audit Sampling:** The auditor shall evaluate-

- (a) The results of the sample; and
- (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

**3.12.4 Sample Selection Methods:** Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample.



Some of the important methods of selecting the sample are discussed below -

- (1) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below—
  - (i) **Simple random sampling:** Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 55,000 to ₹ 2,25,000 and not in the range between ₹ 525 to ₹ 10,50,000.
  - (ii) **Stratified Sampling:** This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. For example

in the above case, trade receivables balances may be divided into four groups as follows:-

- (a) balances in excess of ₹ 10,00,000;
- (b) balances in the range of ₹ 7,75,000 to ₹ 10,00,000;
- (c) balances in the range of ₹ 5,50,000 to ₹ 7,75,000;
- (d) balances in the range of ₹ 2,25,000 to ₹ 5,50,000; and
- (e) balances below ₹ 2,25,000.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group *i.e.* balances in excess of ₹ 10,00,000, the auditor may examine all the items; from the second group 25 per cent of the items; from the third group 10 per cent of the items; and from the lowest group 2 per cent of the items may be selected.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

(2) **Interval sampling or systematic sampling:** It involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example every 20th voucher) or a monetary totals (for example every ₹ 10,000 in the cumulative value of the population). When using systematic selection, the auditor should determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, particular branch sales occur only as every 100th item and the sampling interval selected is 100. The result would be that either the auditor would have selected all or none of the sales of that particular branch. To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

- (i) **Block Sampling:** This method involves the selection of a defined block of consecutive items. For example take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion. There is a close similarity between this method and non-statistical sampling. Consequently it has similar characteristics, namely, simplicity and economy. On the other hand there is a risk of bias and of establishing a pattern of selection which may be noted by the auditees.
- (ii) **Cluster sampling:** This method involves dividing the population into groups of items known as clusters. A number of clusters are randomly selected from all the clusters rather than individual items of the population. Cluster sampling can be used together with

both unrestricted random and stratified sampling, for example 500 to 540, 2015 to 2055 etc. The first item *i.e.* 500, 2015 is randomly selected from random number tables. The items of selected cluster can either be checked completely or a randomly selected proportion of them can be examined.

The cluster is less effective for a given sample size than unrestricted random and stratified samples as items are not individually selected. However, the time saved can be utilised to have a larger sample to make the sample results more reliable.

As per SA 530, the auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

(3) **Monetary Unit Sampling:** It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) **Haphazard sampling:** Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

**3.12.5 Advantages of Statistical Sampling in Auditing:** The advantages of statistical sampling may be summarized as follows -

- (1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (2) The sample selection is more objective and thereby more defensible.
- (3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (4) It provides a means for deriving a “calculated risk” and corresponding precision (sampling error) *i.e.* the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort, for instance when exact accuracy is required or in case of legal requirements etc.

**(Note: Student may refer SA 530 reproduced in Auditing Pronouncements for better understanding of the topic)**

### 3.13 Audit Risk

Students may recall that there is unavoidable risk that even some material misstatements may remain undiscovered due to the test nature and other inherent limitations of any system of internal control. SA-500 on “Audit Evidence” also makes it clear that the auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. An auditor’s judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Therefore, it becomes significant that an auditor is aware of risks which are inherent in any audit with reference to materiality of transactions involved and accordingly test and evaluate internal control systems so as to assess the extent of risk. In the following paragraphs, first of all various facts of audit risks are discussed followed by relationship between materiality and audit risk.

Low-risk areas are those which require the application of routine “nuts and bolts” audit procedures in the ordinary course of vouching, casting, checking, etc., at both compliance and substantive stages, usually occupying up to 80% of all audit effort. High-risk areas are those which should be the primary concern of partners and senior managers, and will include such matters as:

- (a) adequacy of provisions;
- (b) full disclosure of liabilities, including contingent liabilities;
- (c) interpretation of SAs and company legislation;
- (d) post-balance sheet review of subsequent events;
- (e) analytical reviews on draft financial statements;
- (f) implications of tax legislation;
- (g) detecting overstatement of assets, e.g. by capitalising expenditure;
- (h) identifying high-value items and ‘error-prone’ conditions; and
- (i) drafting the audit report itself.

**3.13.1 Concept of audit risk:** Audit risk is the risk that an auditor may give an inappropriate opinion on financial information that is materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level or while verifying various transactions and balance-sheet items. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement. Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor’s business

risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

[Note: Types of risk are discussed separately in this chapter.]

**Identifying and Assessing the Risks of Material Misstatement:** The auditor shall identify and assess the risks of material misstatement at-

- (1) the financial statement level; and
  - (2) the assertion level for classes of transactions, account balances, and disclosures;
- to provide a basis for designing and performing further audit procedures.

***Thus, according to SA 315, the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.***

**(1) Assessment of Risks of Material Misstatement at the Financial Statement Level**

(a) Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

(b) Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

(c) The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- ◆ Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- ◆ Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

(d) SA 705, "Modifications to the Opinion in the Independent Auditor's Report" establishes requirements and provides guidance in determining whether there is a need for the auditor to



consider a qualification or disclaimer of opinion or, as may be required in some cases, to withdraw from the engagement where this is legally possible.

**(2) Assessment of Risks of Material Misstatement at the Assertion Level**

Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

**The Uses of Assertions**

1. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.
2. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms-
  - (a) Assertions about classes of transactions and events for the period under audit:
    - (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
    - (ii) Completeness—all transactions and events that should have been recorded have been recorded.
    - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
    - (iv) Cut-off—transactions and events have been recorded in the correct accounting period.
    - (v) Classification—transactions and events have been recorded in the proper accounts.
  - (b) Assertions about account balances at the period end:
    - (i) Existence—assets, liabilities, and equity interests exist.
    - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
    - (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
    - (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

- (c) Assertions about presentation and disclosure:
- (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.
  - (ii) Completeness—all disclosures that should have been included in the financial statements have been included.
  - (iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.
  - (iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.
3. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.
4. When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph 2, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

**For the purpose of Identifying and Assessing the Risks of Material Misstatement, the Auditor shall:**

- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
- (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
- (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

**Process of Identifying Risks of Material Misstatement:** Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

As per SA 200, the risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks;

### 3.43 Auditing and Assurance

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they exist independently of the audit of the financial statements. The nature of each of these types of risk and their interrelationship is discussed below-

**Inherent Risk:** The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. It is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

**Control Risk:** The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

**Detection Risk:** The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material,

either individually or when aggregated with other misstatements. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

**Interrelationship of the components of audit risk:** Inherent and control risks differ from detection risk in that they exist independently of an audit of financial information. Inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce an acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

**3.13.2 Materiality and Audit Risk:** SA-320 on "Materiality in Planning and Performing an Audit" states that the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. According to it, misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. It stresses that the assessment of what is material is a matter of professional judgement.

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The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

- (a) Identifying and assessing the risks of material misstatement;
- (b) Determining the nature, timing and extent of further audit procedures; and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high. The auditor reduces detection risk by performing substantive procedures - the more extensive the procedures performed, the lower the detection risk. The nature and timing of substantive procedures will also affect the detection risk, for example, confirmation with third parties will lead to lower detection risk than reliance on internal data, as will procedures carried out closer to year-end.

The auditor's assessment of audit risk may change during the course of an audit. For example, in planning the audit, the auditor may believe that he has low inherent and control risk based on his assessment of the probability of errors occurring and on his review and testing of the system of internal control. After performing audit procedures, however, the auditor may conclude that his earlier assessment was too low. In this case, he will have to carry out additional audit procedures in order to reduce the level of detection risk and achieve audit risk at the level originally planned.

**(Note: Student may refer SA 320 reproduced in Auditing Pronouncements for better understanding of the topic)**

### 3.14 Surprise Checks

The surprise checks also constitute an important part of normal audit procedures. Audit procedures cannot consist merely of any set of rules or precepts to be applied to all and every situation but must be allowed to develop in the light of experience with regard to the circumstances of each audit. An element of surprise can significantly improve the effectiveness of an audit and therefore, wherever practicable, an element of surprise should be incorporated into the audit programme.

The element of surprise in an audit can be both with regard to the time of the audit, that is the selection of the date at which the auditor visits the clients' office to carry out the audit and the selection of the items which are subjected to audit.

Surprise checks are mainly intended to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently

and kept up-to-date. It has often been found that manipulations and frauds are facilitated under a system of book-keeping which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations. Surprise checks are a useful method of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

While surprise checks would generally be appropriate in most cases, they are particularly appropriate in cases where the auditor is not satisfied with regard to the system of internal control, or where the company is a very large one or has diversified activities or numerous branches, leading to remoteness of control between top management and various persons in charge of the company's operations at different locations. Surprise checks are also particularly relevant in respect of certain items, for example, cash, investments, stores and inventories, statutory registers normally required to be examined for the purposes of audit, etc. They also have great relevance to ensure that the books of prime entry, for example, the cash book, sales and purchase journals etc. have been kept up-to-date. When computerized information system is being used, surprise checks, through the use of test-checks etc. are important to ensure that the programmes are operating satisfactorily.

The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit.

In the case of an audit of a company the auditor is appointed at the Annual General Meeting to hold office until the next Annual General Meeting. He is not appointed for a particular accounting year. Consequently, he has the right of examination of the accounts and records of the company at any time during the period covered by his appointment, insofar as it is necessary for the purposes of his report. He may, therefore, carry out surprise checks of transactions beyond the end of the accounting year for which he is reporting.

Surprise checks are a part of the normal audit and the results of such checks are therefore important primarily to the auditor himself in deciding the scope of his audit and submitting his report thereon. If the surprise check reveals a weakness in the system of internal control or any fraud or error or the fact that any book or register has not been properly maintained or kept up-to-date, the auditor should communicate the same to the management and ensure that action is taken on the matters communicated by him. It does not necessarily follow that all or any of the matters communicated to the management should form part of the auditor's report on the accounts. Whether the items should also be included in the auditor's report on the accounts is a matter for the auditor to decide in the light of the circumstances of each case. In arriving at his decision he must consider, *inter alia*, the magnitude of the amounts

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involved, whether the error or deficiencies pointed out have been rectified or the weaknesses in the internal control system corrected and the extent to which the accounts reported upon are affected by the matters stated by him in his report to the management.

The Council therefore makes the following recommendations:

- (1) Surprise checks should be considered as a desirable part of each audit.
- (2) The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include:
  - (a) Verification of cash and investments.
  - (b) Test-verification of stores and inventories and the records relating thereto.
  - (c) Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.
- (3) The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.
- (4) The results of the surprise checks should be communicated to the management if they reveal any weakness in the system of internal control or any fraud or error or deficiency in the maintenance of records.
- (5) The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.
- (6) It is not necessary in all cases for the results of the surprise checks to be included in the auditors' report on the accounts. They should, however, be included if in the opinion of the auditor they are material and affect a true and fair view of the accounts on which he is reporting.

### **3.15 Obtaining Certificate from Management**

While conducting an audit, the auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. One such area involves verification of liabilities, in general, and contingent liabilities in particular. In such cases, it is advisable for the auditor to obtain a written representation from the management as to the fact whether all contingent liabilities have been disclosed and are complete in all respects. Even in normal circumstances, obtaining a certificate from the management would provide a corroborating evidence to support the evidence obtained from other sources. In any case, the fact remains that it is the management which is responsible for preparation of financial information. Therefore, it would be in order to obtain an appropriate certificate from the management that it has approved the financial information prepared by them. Now section 134(5) of the Companies Act, 2013 provides that the Board shall have to give a statement that financial statements are their responsibility.

SA-580, "Written Representations", deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

The objectives of the auditor are:

- (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
- (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

It makes it absolutely clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available. For example, a representation by management as to the quantity, existence and cost of inventories is no substitute for adopting normal audit procedures regarding verification and valuation of inventories. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter.

**(Note: Student may refer SA 580 reproduced in Auditing Pronouncements for better understanding of the topic)**